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## ARIZONA INDIVIDUAL INCOME TAX PROCEDURE ITP 07-1

Procedure for Calculating Credit for Taxes Paid to Another State  
or Country by Arizona Resident Individuals

(This procedure supersedes ITP 97-1)

This procedure is intended to compliment Arizona Form 309-R and provide guidance with respect to determining the amounts required to be entered on lines 1 through 3 and 13a through 13e of the Arizona Form 309-R.

### **APPLICABLE LAW:**

Arizona Revised Statutes (A.R.S.) § 43-1071 sets forth the conditions under which residents are allowed an Arizona income tax credit for income taxes paid to another state or country.

*Stearns v. Arizona Department of Revenue*, 212 Ariz. 333, 131 P.3d 1063 (2006), held that the calculation for the credit for taxes paid to another state must be based on taxable income rather than adjusted gross income.

*Shaffer v. Carter*, 252 U.S. 37, 40 S.Ct. 221 (1920), held that states can only tax nonresidents on income sourced within that state.

### **DISCUSSION:**

Arizona resident taxpayers are permitted a credit against Arizona income taxes for net income taxes imposed by and paid to another state (country) when all of the following criteria are met:

1. The income is derived from sources within the other state and is taxable to the other state regardless of the residence of the recipient.
2. The other state does not allow Arizona residents a tax credit against income taxes which are imposed by the other state.
3. The tax imposed by the other state is on income which is also taxed by Arizona.

The credit is limited to the lesser of the Arizona tax imposed on income taxed by both Arizona and the other state or the other state's tax imposed on income taxed by both Arizona and the other state.

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In *Stearns*, the Arizona Court of Appeals overruled the department's interpretation of the formula for calculating the credit for taxes paid to another state. The department's former method of calculating the credit was based on adjusted gross income. Under the court's decision, a "taxpayer's 'taxable income' forms the denominator of the tax credit" and "the numerator of the fraction, which consists of 'income subject to tax' in both the other state and Arizona, is equivalent to that portion of the out-of-state income that is taxable in both states." *Stearns* at 335-36, 131 P.3d at 1065-66. Therefore, to calculate the amount of the Arizona income tax liability that relates to the income subject to tax in both Arizona and the other state, the following formula is used:

$$\frac{\text{Portion of Arizona taxable income also taxable in the other state}}{\text{Arizona taxable income}} \times \text{Arizona tax liability}$$

To calculate the portion of Arizona taxable income that is also taxable in the other state, the taxpayer must first determine what portion of the out-of-state income is included in Arizona taxable income. To determine what portion of out-of-state income is included in Arizona taxable income, the taxpayer must apportion deductions and exemptions between income reportable to both Arizona and the other state and income reportable to Arizona only. The taxpayer must then compare the portion of out-of-state income included in Arizona taxable income to the amount of out-of-state income included in the taxable income of the other state. The portion of the Arizona taxable income that is also taxable in the other state is the lesser of the amount of out-of-state income included in Arizona taxable income or the amount of out-of-state income included in the other state's taxable income.

### **PROCEDURE:**

Prior to computing this credit, the taxpayer must determine the following amounts:

- Each income item to the extent included in Arizona adjusted gross income and the adjusted gross income equivalent of the other state. (Lines 1 through 3 of Form 309-R.)
- The portion of Arizona taxable income that is also taxable in the other state.
- The other state's taxable income computed under the equivalent of A.R.S. Title 43, Chapter 10, Article 6. (This amount may not be shown on a specific line of the return filed with the other state.) Since the other state can only tax a nonresident on income which is sourced to that state, the other state's taxable income must include only income sourced to that other state under its income tax laws. Source income is generally income derived from property located within a state or from an activity carried on within a state when the income recipient is a nonresident. If the other state computes its tax on all income from everywhere and then prorates the tax to reflect the tax actually imposed on income sourced to the other state, the taxpayer must compute the taxable income under the

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equivalent of A.R.S. Title 43, Chapter 10, Article 6. (Lines 13a through 13e of Form 309-R.)

Once these amounts are determined, the taxpayer must compute the credit using the formula provided above.

The following examples illustrate how to complete lines 1 through 3 and lines 13a through 13e on Form 309-R.

#### **Example 1:**

**Facts:** Mr. and Mrs. M are Arizona residents. Mr. M is an active duty military member who is stationed in State X. Mr. M receives wages from the military and from a part-time job in State X. Mrs. M receives wages from part-time employment in State X. Mr. and Mrs. M also have Arizona rental property. During the taxable year, Mr. and Mrs. M received the following income.

Mr. M's military wages	\$ 15,000
Mr. M's part-time employment wages	\$ 5,000
Mrs. M's part-time employment wages	\$ 5,000
Rental income from AZ property	\$ 20,000
Total income	<u>\$ 45,000</u>

As Reported on State X Return		As Reported on Arizona Return	
Federal adjusted gross income	\$ 45,000	Federal adjusted gross income	\$ 45,000
Less non-State X income (military and rental income)	(35,000)	Less subtractions from income (military income \$15,000 and dependent exemption \$2,300)	(17,300)
Less subtraction for two earner income	(1,000)	Arizona adjusted gross income	\$ 27,700
State X adjusted gross income	\$ 9,000		

Mr. and Mrs. M would complete lines 1a through 3 of Arizona Form 309-R as follows:	
1a Wages	\$10,000
1b	
1c	
1d	
2 Add lines 1a through 1d	\$10,000
3 Amount of income from line 2 included in Arizona adjusted gross income and the adjusted gross income equivalent of the other state or country	\$ 9,000
Mr. and Mrs. M must report Mr. M's part-time employment wages of \$5,000 and Mrs. M's part-time employment wages of \$5,000 to Arizona. There is no subtraction allowed under Arizona law that is related to that income. Therefore, \$10,000 of the part-time wage income is included in Mr. and Mrs. M's Arizona adjusted gross income. Mr. and Mrs. M also include the \$10,000 in income for State X. However, since \$1,000 of the \$10,000 wage income is subtracted from State X adjusted gross income under State X law, only \$9,000 of that \$10,000 is included in State X adjusted gross income. The amount of part-time wage income included in both Arizona adjusted gross income and in State X adjusted gross income is \$9,000.	

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### **Example 2:**

**Facts:** Mr. and Mrs. D are residents of Arizona. Mr. D sold real estate located in State XYZ and realized a \$20,000 capital gain. Mr. and Mrs. D also had capital losses of \$3,000 which were not related to the real estate located in State XYZ. Therefore, for federal income tax purposes, Mr. and Mrs. D reported \$17,000 of capital gain income. During the taxable year, Mr. and Mrs. D had the following income.

Interest income	\$ 40,000
Dividend income	\$ 4,000
Capital gains from State XYZ	\$ 20,000
Capital losses	\$ (3,000)
Total income	<u>\$ 61,000</u>

As Reported on State XYZ Return		As Reported on Arizona Return	
State XYZ gross income	\$ 20,000	Federal adjusted gross income	\$ 61,000
Less State XYZ adjustments	(0)	Dependent exemption \$2,300	(2,300)
State XYZ adjusted gross income	\$ 20,000	Arizona adjusted gross income	\$ 58,700

Mr. and Mrs. D would complete lines 1a through 3 of Arizona Form 309-R as follows:	
1a Capital gains	\$20,000
1b	
1c	
1d	
2 Add lines 1a through 1d	\$20,000
3 Amount of income from line 2 included in Arizona adjusted gross income and the adjusted gross income equivalent of the other state or country	\$20,000
Mr. and Mrs. D must include the \$20,000 of capital gain from the sale of property located in State XYZ in Arizona adjusted gross income. (Note: For the purpose of computing the credit, the \$20,000 State XYZ capital gain is not offset by non-State XYZ capital losses included in federal adjusted gross income, since such losses are not included in State XYZ adjusted gross income). Mr. and Mrs. D must also include the \$20,000 capital gain from the sale of property located in State XYZ in State XYZ adjusted gross income. There are no additions or subtractions related to that income required under either Arizona law, or State XYZ law. Therefore, the amount of capital gain included in Arizona adjusted gross income and State XYZ adjusted gross income is \$20,000.	

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### **Example 3:**

**Facts:** Mr. and Mrs. F are Arizona residents who derive income from a farm in State XY. During the taxable year for which the credit is being claimed, Mr. and Mrs. F had the following income.

Interest income	\$ 38,000
Dividend income	\$ 4,000
Farm income from State XY	<u>\$ 16,000</u>
Total income	<u>\$ 58,000</u>

As Reported on Arizona Return	
Federal adjusted gross income	\$ 58,000
Less dependent exemption \$2,300	(2,300)
Arizona adjusted gross income	\$ 55,700
Itemized deductions	10,000
Personal exemption	6,300
Arizona taxable income	39,400
Arizona tax	1,077
Clean Elections Fund tax reduction	10
Balance of Arizona tax	1,067

As Reported on State XY Return		As Reported on State XY Income Allocation Schedule			
			Column A Income from federal return	Column B Income from Column A from State XY sources	Column C Income from Column A reportable to State XY
1. Federal adjusted gross income	\$ 58,000				
2. Plus State XY additions	0	1. Wages			
3. Less State XY subtractions	0	2. Interest	38,000		38,000
4. State XY adjusted gross income	<u>\$ 58,000</u>	3. Dividends	4,000		4,000
5. Income from State XY sources	\$ 16,000	4. Farm Income	16,000	16,000	16,000
6. State XY taxable income. Enter the greater of line 4 or line 5	\$ 58,000	5. Capital Gains			
7. Income tax from tables	\$ 3,308	6. Rents, Royalties, Partnership, Sub S			
8. Divide line 5 by line 6	0.2759	7. Other Income			
9. State XY tax on income sourced to State XY. Multiply line 7 by line 8	\$ 913	8. Total income	58,000	16,000	58,000

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#### Credit Computation:

Mr. and Mrs. F must report State XY farm income of \$16,000 to both Arizona and to State XY. Since there are no additions or subtractions related to that income required under either Arizona law, or State XY law, \$16,000 of that income is included in Arizona adjusted gross income and in State XY adjusted gross income. Additionally, since State XY computes its tax on taxable income from everywhere and then prorates the tax to reflect the tax actually imposed on State XY source income, Mr. and Mrs. F must complete lines 13a through 13e of Arizona Form 309-R.

Mr. and Mrs. F complete the Arizona Form 309-R as follows:

#### Arizona Form 309-R

	Description of income items	Amount
1a	Farm income	16,000
1b		
1c		
1d		
2	Add lines 1a through 1d	16,000
3	Amount of income from line 2 included in Arizona adjusted gross income and the adjusted gross income equivalent of the other state or country	16,000
4	Arizona adjusted gross income	55,700
5	Exemptions for age 65 or over, blind, dependents or qualifying parents or ancestors	2,300
6	Add line 4 to line 5	58,000
7	Divide the amount on line 3 by the amount on line 6. Carry the result to 4 decimal places	. 2 7 5 9
8	Itemized deductions or standard deduction claimed on the Arizona return for the taxable year	10,000
9	Personal exemption claimed on the Arizona return for the taxable year and amount entered on line 5	8,600
10	Add lines 8 and 9	18,600
11	Multiply the amount on line 10 by the decimal on line 7	5,132
12	Portion of out-of-state income taxable to Arizona. Subtract line 11 from line 3	10,868

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13	Other state or country taxable income. If you have filed a return with a state that computes its tax on all income from everywhere and then prorates the tax to reflect tax imposed on source income, complete lines 13a through 13e. Otherwise, skip lines 13a through 13d, and enter your taxable income from the other state's return on line 13e income					
13a	Other state taxable income from everywhere	58,000				
13b	Other state source income	16,000				
13c	Total income from everywhere	58,000				
13d	Divide line 13b by line 13c	. 2 7 5 9				
13e	If you were required to complete lines 13a through 13d, multiply the amount on line 13a by the decimal on line 13d		16,002			
14	Out-of-state income taxable by both Arizona and the other state or country. Enter the smaller of the amount entered on line 12 or line 13e		10,868			
15	Arizona taxable income		39,400			
16	Divide the amount on line 14 by the amount on line 15. Carry the result to 4 decimal places		. 2 7 5 8			
17	Arizona tax		1,067			
18	Multiply the amount on line 17 by the decimal on line 16		294			
19	Tax paid to the other state or country		913			
20	Credit: Enter the smaller of line 18 or line 19		294			

Gale Garriott, Director

Signed: September 21, 2007

### Explanatory Notice

The purpose of a tax procedure is to provide procedural guidance to the general public and to Department personnel. A tax procedure is a written statement issued by the Department to assist in the implementation of tax laws, administrative rules, and tax rulings by delineating procedures to be followed in order to achieve compliance with the law. Relevant statute, case law, or administrative rules, as well as a subsequent procedure, may modify or negate any or all of the provisions of any tax procedure. See GTP 96-1 for more detailed information regarding documents issued by the Department of Revenue.